

## Message Text

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60

ACTION EUR-25

INFO OCT-01 ISO-00 ACDA-19 AID-20 CIAE-00 COME-00 EB-11

FRB-02 INR-10 NSAE-00 RSC-01 TRSE-00 XMB-07 OPIC-12

SP-03 CIEP-02 LAB-06 SIL-01 OMB-01 PM-07 H-03 L-03

NSC-07 PA-04 PRS-01 SS-20 USIA-15 COA-02 AGR-20 SWF-02

DRC-01 FEA-02 INT-08 /216 W  
----- 056414

R 271500Z JUN 74

FM AMEMBASSY REYKJAVIK

TO SECSTATE WASHDC 4608

INFO SECDEF WASHDC

USMISSION NATO

USOECD PARIS 623

COMICEDEFOR

CINCLANT

AMEMBASSY BONN

AMEMBASSY COPENHAGEN

AMEMBASSY LONDON

AMEMBASSY OSLO

AMEMBASSY STOCKHOLM

C O N F I D E N T I A L REYKJAVIK 0873

E.O. 11652: GDS

TAGS: ECON IC

SUBJECT: THE ICELANDIC ECONOMY AT MID-YEAR: MAJOR ADJUSTMENTS NEEDED

1. ECONOMIC PROBLEMS CAUSED THE MAY 9 DISSOLUTION OF THE ALTHING  
AND NOW PROVIDE ONE OF TWO MAJOR ISSUES - ALONG WITH DEFENSE  
CONTROVERSY - ON WHICH THE JUNE 30 ELECTION WILL BE DECIDED.  
ICELAND'S PRESENT DIFFICULTIES, PERHAPS BEST DESCRIBED AS MORE  
REAL THAN APPARENT, ARE LARGELY RESULT OF GROSS ECONOMIC MISMANAGE-  
MENT BY GOP. SITUATION IS CHARACTERIZED BY RAMPANT INFLATION ON  
ORDER OF 45 PERCENT ANNUALLY, AN OVERVALUED CURRENCY, DEFICIT  
OPERATIONS THROUGHOUT CRUCIAL EXPORT SECTOR, DECLINING EXPORT  
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PRICES, AND INCREASINGLY TIGHT FOREIGN EXCHANGE RESERVES WITHO

TRADE DEFICIT OF \$42 MILLION THROUGH MAY 31. COMPARED WITH SURPLUS OF \$4 MILLION DURING SAME PERIOD 1973. HOWEVER, AVERAGE CITIZEN CONTINUES TO ENJOY HIGHEST STANDARD OF LIVING IN NATION'S HISTORY AND HAS YET TO FEEL FULL IMPACT OF BELT-TIGHTENING WHICH ANY NEW GOVERNMENT WILL BE FORCED TO IMPLEMENT AT EARLIEST POSSIBLE TIME.

2. IN 1973 ICELAND EXPERIENCED INFLATION OF 28.3 PERCENT AND, BECAUSE OF LINKAGE OF WAGES TO COST OF LIVING, A ROUGHLY PARALLEL WAGE INCREASE OF 35 PERCENT. HOWEVER, PRICE OF FISH (FROZEN COD BLOCK) IN US SOARED 70 PERCENT TO 82 CENTS EARLY IN 1974 FROM 48 CENTS AT START OF 1973, KEEPING KEY FISH EXPORT INDUSTRY PROFITABLE DESPITE LARGE JUMP IN LOCAL COSTS, AND ENABLED GOI TO CONTINUE EXTRAVAGANT SPENDING PROGRAM. LOCAL WAGES AND CERTAIN IMPORTANG PRICES SET BY GOVERNMENT WERE GEARED TO HIGHEST FISH PRICES AND KRONA WAS REVALUED FROM 98 TO DOLLAR DOWN TO 83 TO DOLLAR. HIGHER INCOME FROM FISH EXPORTS WAS SPREAD QUICKLY THROUGH THE ECONOMY LEADING TOH RAPIDLY INCREASED IMPORTS.

3. WITHIN PAST FEW MONTHS, HOWEVER, TWO FACTORS - A HIGH WAGE SETTLEMENT AND DECLINING US FISH PRICES - HAVE COMPLETELY CHANGED SITUATION. AT END OF FEBRUARY UNIONS EXACTED AN AVERAGE WAGE INCREASE OF OVER 25 PERCENT, WHICH WAS AUGMENTED A FEW DAYS LATER BY A 6 PERCENT COST-OF-LIVING INCREASE. SOME JOB CATEGORIES RECEIVED AS MUCH AS 45 PERCENT INCREASE. FACED WITH A FURTHER WAGE INCREASE OF SOME 15 PERCENT WHICH WOULD HAVE TAKEN EFFECT JUNE 1 AS RESULT OF INCREASES IN COST OF LIVING BETWEEN FEBRUARY 1 AND MAY 1, GOVERNMENT ATTEMPTED TO INSTITUTE VARIETY OF CONTROLS THROUGH ALTHING. WHEN THIS PROVED IMPOSSIBLE, ALTHING WAS DISSOLVED NEW ELECTIONS WERE CALLED, AND A SERIES OF BAND-AID TYPE MEASURES ADOPTED. THESE INCLUDED 4 PERCENT DEVALUATION, 25 PERCENT IMPORT DEPOSIT SCHEME, 10 PERCENT ADDITIONAL SURCHARGE ON CAR IMPORTS, HEAVY AGRICULTURAL SUBSIDIES, INCREASED TAXES ON ALCOHOL AND TOBACCO, AND MOST IMPORTANTLY A WAGE AND PRICE FREEZE THROUGH AUGUST 31. TAKEN TOGETHER, THESE ECONOMIC MEASURES DEAL NOT AT ALL WITH THE ROOT CAUSES OF ICELAND'S REAL PROBLEMS - INFLATION, BALANCE OF PAYMENTS DIFFICULTIES, AND A SICK EXPORT SECTOR - BUT ARE RATHER DESIGNED TO GET PAST JUNE 30 WITHOUT A MAJOR CALAMITY SUCH AS A FURTHER 15 PERCENT WAGE INCREASE OR THE TOTAL DISAPPEARANCE OF THE COUNTRY'S FOREIGN EXCHANGE RESERVES. CONFIDENTIAL

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TO THIS DEGREE THESE MEASURES HAVE BEEN SUCCESSFUL AND AVERAGE ICELANDER, WHILE NO DOUBT AWARE THAT SOMETHING IS AMISS, HAS YET TO WITNESS THE INEVITABLE CRUNCH WHICH MUST OCCUR IF NATION'S ECONOMY IS EVER TO RETURN TO SOUND BASIS WITHOUT BENEFIT OF ANOTHER LARGE INCREASE IN EXPORT PRICES. SUCH AN INCREASE IS CONSIDERED MOST UNLIKELY.

4. PROBABLY BECAUSE OF IMPORT DEPOSIT REQUIREMENT, THE DECLINE

IN ICELAND'S RESERVES HAS BEEN STOPPED TEMPORARILY AND THE RESERVES ARE NOW ABOUT \$30-\$33 MILLION, WHICH IS ABOUT ONE MONTH'S IMPORTS. AT BEGINNING OF 1974 THEY WERE ABOUT \$74 MILLION.

5. THE TEMPORARY MEASURES HAVE DONE LITTLE TO IMPROVE CONDITIONS IN THE ALL-IMPORTANT FREEZING PLANT INDUSTRY WHICH IS IN SERIOUS TROUBLE, A FACT NOT YET WIDELY RECOGNIZED. AT LEAST TWO PLANTS IN COOPERATIVE CHAIN HAVE TEMPORARILY CLOSED AND ACCORDING TO HEAD OF COOPERATIVE FISHERIES DIVISION ALL PLANTS ARE LOSING MONEY ON EVERY POUND OF FISH PACKED. LARGE STOCKS OF FROZEN COD BLOCK HAVE ACCUMULATED AND SOME 15,000 TONS OF FISH MEAL REMAIN UNSOLD.

6. SERIOUSNESS OF PRESENT SITUATION IS SHOWN BY UNUSUALLY STRONG LANGUAGE IN RECENT SPEECH BY GOVERNOR OF CENTRAL BANK JOHANNES NORDAL AT BANK'S ANNUAL MEETING. NORDAL NOTED THAT "NO ONE ACQUAINTED WITH FACTS DOUBTS THAT ICELANDIC NATION NOW FACES UNUSUALLY DIFFICULT ECONOMIC PROBLEMS, WHICH HAVE NOT BEEN TACKLED AS SOON AS THEY SHOULD HAVE. INFLATIONARY DEVELOPMENTS HAVE OCCURRED RECENTLY WHICH MUST JEOPARDIZE BOTH EXTERNAL POSITION OF ECONOMY AND ALL ORGANIZED ECONOMIC ACTIVITY IF IMMEDIATE STEPS ARE NOT TAKEN. IN FACE OF SUCH DIFFICULTIES CENTRAL BANK MUST MAKE IT A PRIMARY GOAL TO PRESERVE EXTERNAL CONFIDENCE AND LIQUIDITY OF THE ECONOMY BECAUSE ON THESE DEPENDS THE ECONOMIC INDEPENDENCE AND FUTURE PROSPERITY OF THE NATION. BANK IS THEREFORE FORCED TO EXERCISE UTMOST RESTRAINT IN ALL ITS TRANSACTIONS BOTH WITH BANKS AND PUBLIC AGENCIES."

7. EXACTLY WHAT REMEDIES WILL BE TAKEN IS STILL UNKNOWN; THEY WILL NO DOUBT DEPEND ON WHAT PARTIES FORM NEXT GOVERNMENT. CERTAIN STEPS ARE CLEARLY CALLED FOR INCLUDING LARGE CUTBACK IN GOVERNMENT EXPENDITURES, SELECTIVE RESTRICTIONS ON BANK LENDING WITH PROBABLY A SUBSTANTIAL INCREASE IN INTEREST RATES, A PARTIAL, IF NOT COMPLETE, SEVERING OF WAGES FROM COST OF LIVING INDEX (A MOST DIFFICULT MOVE  
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POLITICALLY), CEILING ON GROWTH OF MONEY SUPPLY, AND A VERY SIZEABLE DEVALUATION OF KRONA. REGARDING LAST STEP, GOI HAS GRADUALLY ALLOWED KRONA TO DECLINE ALMOST 12 PERCENT SINCE BEGINNING OF 1974, BUT THIS HAS BEEN NOWHERE NEAR SUFFICIENT TO ALLOW EXPORT INDUSTRIES TO OPERATE PROFITABLY OR ADEQUATELY TO CURB IMPORTS. A MAJOR DEVALUATION HAS BEEN NEEDED AT LEAST SINCE MARCH WAGE SETTLEMENTS BUT POLITICAL CONSIDERATIONS HAVE MADE THIS IMPOSSIBLE. INSTEAD, IMPORT RESTRICTIONS WERE IMPOSED TO STEM OUTFLOW OF FOREIGN EXCHANGE BUT THIS HAS DONE NOTHING TO ENCOURAGE EXPORTS.

8. ADMITTEDLY SOME FACTORS BEYOND ICELAND'S CONTROL HAVE CONTRIBUTED TO THE DIFFICULTIES. HIGHER OIL PRICES AND HIGHER PRICES FOR OTHER IMPORTS HAVE PUT INCREASED PRESSURE ON RESERVES AND HELPED FEED DOMESTIC INFLATION. BUT GOVERNMENT HAS HAD NO CLEAR

ECONOMIC POLICY OF ANY KIND BEYOND TRYING TO STAY ONE STEP AHEAD  
OF DISASTER. AT A TIME WHEN AVERAGE EXPORT PRICES WERE RISING 42  
PERCENT AND IMPORT PRICES ONLY 24 PERCENT (AS IN 1973) GOI  
EXERCISED MINIMUM OF CONTROL AND GEARED ECONOMY TO HIGHEST  
LEVEL OF EXPORT REVENUE. THE SITUATION IS CORRECTABLE AS LONG  
AS THE NEW GOVT IS WILLING TO INTRODUCE UNPOPULAR MEASURES  
AND AS LONG AS THERE ARE FISH TO BE CAUGHT BY ICELAND. WE CAN  
ASSUME THAT THESE MEASURES WILL BE INSTITUTED BY WHATEVER GOVT IS  
FORMED, SOME AS EARLY AS JULY.  
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## Message Attributes

**Automatic Decaptioning:** X  
**Capture Date:** 01 JAN 1994  
**Channel Indicators:** n/a  
**Current Classification:** UNCLASSIFIED  
**Concepts:** ECONOMIC CONDITIONS, INFLATION, FISHING INDUSTRY, EXPORTS, ECONOMIC REPORTS, BALANCE OF PAYMENTS, PRICES, ANTINFLATIONARY PROGRAMS, FOREIGN EXCHANGE HOLDINGS, FISH PROCESSING, INDUSTRIAL PLANTS, CODFISH, DEVALUATIONS, KRONA  
**Control Number:** n/a  
**Copy:** SINGLE  
**Draft Date:** 27 JUN 1974  
**Decaption Date:** 01 JAN 1960  
**Decaption Note:**  
**Disposition Action:** RELEASED  
**Disposition Approved on Date:**  
**Disposition Authority:** boyleja  
**Disposition Case Number:** n/a  
**Disposition Comment:** 25 YEAR REVIEW  
**Disposition Date:** 28 MAY 2004  
**Disposition Event:**  
**Disposition History:** n/a  
**Disposition Reason:**  
**Disposition Remarks:**  
**Document Number:** 1974REYKJA00873  
**Document Source:** CORE  
**Document Unique ID:** 00  
**Drafter:** n/a  
**Enclosure:** n/a  
**Executive Order:** GS  
**Errors:** N/A  
**Film Number:** D740171-0128  
**From:** REYKJAVIK  
**Handling Restrictions:** n/a  
**Image Path:**  
**ISecure:** 1  
**Legacy Key:** link1974/newtext/t1974068/aaaaagmk.tel  
**Line Count:** 179  
**Locator:** TEXT ON-LINE, ON MICROFILM  
**Office:** ACTION EUR  
**Original Classification:** CONFIDENTIAL  
**Original Handling Restrictions:** n/a  
**Original Previous Classification:** n/a  
**Original Previous Handling Restrictions:** n/a  
**Page Count:** 4  
**Previous Channel Indicators:**  
**Previous Classification:** CONFIDENTIAL  
**Previous Handling Restrictions:** n/a  
**Reference:** n/a  
**Review Action:** RELEASED, APPROVED  
**Review Authority:** boyleja  
**Review Comment:** n/a  
**Review Content Flags:**  
**Review Date:** 22 APR 2002  
**Review Event:**  
**Review Exemptions:** n/a  
**Review History:** RELEASED <22 APR 2002 by cunninfx>; APPROVED <24-Sep-2002 by boyleja>  
**Review Markings:**

Declassified/Released  
US Department of State  
EO Systematic Review  
30 JUN 2005

**Review Media Identifier:**  
**Review Referrals:** n/a  
**Review Release Date:** n/a  
**Review Release Event:** n/a  
**Review Transfer Date:**  
**Review Withdrawn Fields:** n/a  
**Secure:** OPEN  
**Status:** NATIVE  
**Subject:** THE ICELANDIC ECONOMY AT MID-YEAR: MAJOR ADJUSTMENTS NEEDED  
**TAGS:** ECON, ECON, IC  
**To:** STATE  
**Type:** TE  
**Markings:** Declassified/Released US Department of State EO Systematic Review 30 JUN 2005